GENERAL AGREEMENT ON

TARIFFS AND TRADE

RESTRICTED

BOP/W/129
7 November 1989

Limited Distribution

Committee on Balance-of-Payments Restrictions

1989 CONSULTATION WITH ISRAEL

Background Paper by the Secretariat

1. This paper has been prepared in accordance with paragraph 7 of the Declaration on Trade Measures Taken for Balance-of-Payments Purposes adopted by the CONTRACTING PARTIES on 28 November 1979 (BISD 26S/205-209).

I. Israel's previous consultations with the Committee

2. Since Israel's provisional accession to GATT in 1959, eighteen consultations have been held, in 1960-65, 1968-71, 1974, 1976, 1978, 1980, 1982, 1984, 1985 and 1987. At its last consultation with Israel, held on 28 October 1987 (BOP/R/170), the Committee took note of the improvement in Israel's balance-of-payments position since the previous consultation. It commended the Government on the sustained implementation of its economic adjustment policies and on its efforts towards the liberalization of trade, which had produced good results. It recognized that a certain number of problems remained, in particular the need to reduce inflation further, to bring import growth under firmer control through continued demand management measures, and the need to reverse the decline in the savings rate.

3. The Committee welcomed the confirmation which had been given that the import deposit scheme would be abolished in January 1988. It took note of the statements that had been made with regard to the Government's intention to abolish the import levy when it considered the timing to be right, expressed concern that no timetable had yet been announced for its removal, and urged that this be done at the earliest opportunity and that the Government keep in mind in this respect the provisions of paragraph 1(c) of the 1979 Declaration on Trade Measures Taken for Balance-of-Payments Purposes that "whenever practicable, contracting parties shall publicly announce a time schedule for the removal of the measures".

4. The Committee questioned the extent to which the import licensing system in general, and quantitative restrictions in particular, were of value in maintaining or restoring balance-of-payments equilibrium. It expressed views about the adverse effects of the prolonged maintenance of restrictions on the structural adjustment of the Israeli economy. While noting the statement of the representative of Israel that the licensing system was currently operated on a flexible and liberal basis, it saw a need for greater transparency in the administration of the import licensing system and in the nature of the trade restrictions that were being employed.

5. The Committee welcomed Israel's commitment to continue its programme of macroeconomic measures in order to restore a sustainable balance-of-payments situation, demand management being its major tool, and its statement that further progress in this area would permit the removal of the remaining import measures. It urged the Government of Israel to pursue its intentions in these areas resolutely.

II. Trade measures maintained for balance-of-payments purposes

(a) Import licensing

6. The current list of items subject to import licensing is being notified by Israel, classified according to the Harmonized System, in its basic document for the consultation.

(b) Import deposits

7. At the last consultation, Israel confirmed that its import deposit scheme would be phased out in January 1988 (BOP/R/170, paragraph 11). The import deposit scheme has been abolished.

(c) Import levy

8. At the last consultation, Israel stated that it was not considered prudent for the time being to abolish the temporary import levy that had been introduced in 1982 (BOP/R/170, paragraph 11). The import levy remains in effect.

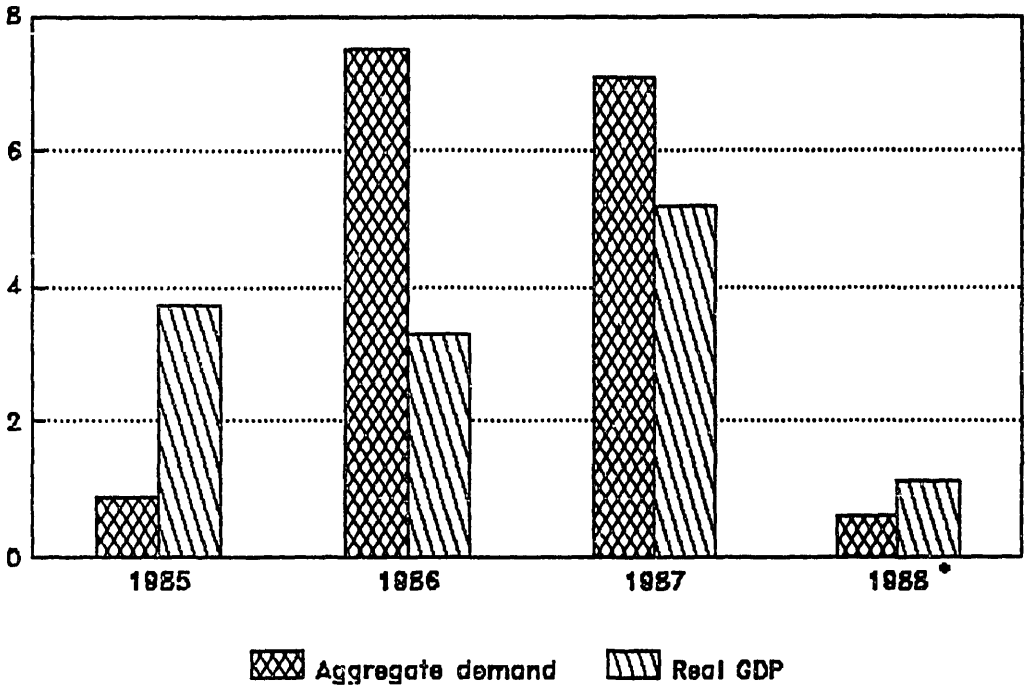
III. Economic and trade developments

Output and prices

(a) Aggregate supply and demand

9. Real GDP growth is estimated to have slowed to 1.1 per cent in 1988 from 5.2 per cent in 1987 (Graph 1). (Latest estimates show a growth of GDP of 1.6 per cent) The slowdown was spread among all components of demand, but exports and fixed investments, the two fastest growing components in 1987, declined most rapidly. For the first time since 1985, aggregate domestic demand - up by just 0.6 per cent last year - increased less than national output.

Graph 1 – Real GDP and aggregate demand
(Annual % changes)



* Estimated

10. In 1987, agricultural output rose by more than 10 per cent after falling by almost 1 per cent the previous year. The industrial sector (including diamond processing) grew by 5.8 per cent, up from 5.2 the previous year. In the services sector, growth was spread unevenly, with construction recording a high growth rate of 8.2 per cent after years of decline.

11. Severe weather explained much of the 4 per cent drop in agricultural output in 1988. In the industrial sector, where gross output is estimated to have declined by almost 3 per cent, rising labour costs and a stable exchange rate policy put downward pressure on the export and import-competing sectors, while civil disturbances affected output and investment, particularly in textiles, clothing and leather products. Construction output, also affected by the disturbances, fell by an estimated 1.3 per cent. The remainder of the services sector, in contrast, expanded enough to produce the increase of 1.1 per cent in total GDP.

12. After the introduction of the stabilization plan in 1985, private consumption grew rapidly in 1986 and 1987. It declined to 3.5 per cent in 1988, reflecting the slower growth of disposable income from late 1987 to mid-1988. Total public consumption (domestic defence expenditures, direct defence imports and civilian expenditures) fell 4.2 per cent in 1988, following growth of over 16 per cent in the previous year, mainly because of a drop in defence imports by more than 24 per cent.

13. In 1987, gross fixed investment was up by 13.7 per cent, following three years of decline. Expectations of overall lower economic activity, higher cost of capital, difficulties in raising funds in the capital market and civil unrest contributed to an estimated 1.2 per cent decline in investment in 1988.

(b) Prices, wages, and employment

14. After rising 185 per cent in 1985, the consumer price index rose by 20 per cent in 1986, before slowing to 16 per cent for the last two years (Table 1). However, a breakdown of changes in prices between tradables and non-tradables shows an increase in the rate of inflation in the non-tradables' sector and a reduction in the rate for tradables in 1987, and higher inflation in the non-tradables' sector than in tradables in 1988 (23 per cent versus 14 per cent in 1987, and 21 per cent against 10 per cent in 1988) (Graph 2). The lower increase in tradables prices reflects international competitive pressures exerted on industries in this sector, resulting from the maintenance of nominal exchange rate stability in an inflationary environment.

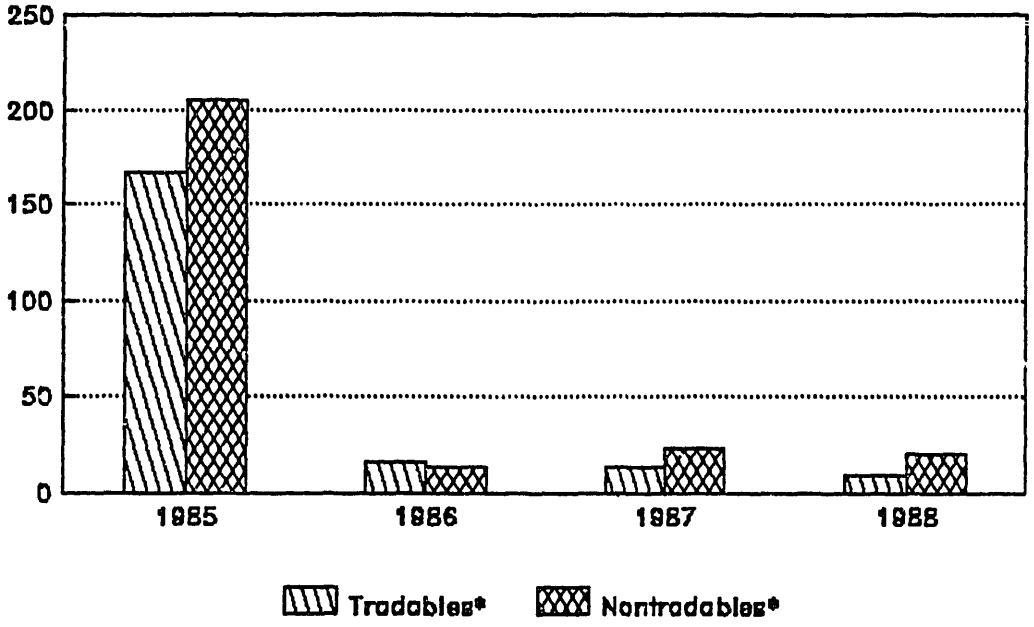
Table 1 - Consumer price indexes, 1985-88
(Annual percentage change)

	1985	1986	1987	1988
General index	185	20	16	16
Controlled prices[1]	249	15	15	17
Uncontrolled prices	170	21	16	16

[1]The weight of the items comprised in this index is about 22.8 per cent of the consumer index.

Source: IMF.

Graph 2 – Tradable and Nontradable price indexes
(Annual % change)



*Excluding fruit, vegetables, and controlled prices.

15. In 1986 and 1987, a combination of excess demand, increases in real wage rates over productivity gains, and devaluation-induced rises in the domestic currency price of tradables generated inflationary pressures. Given the limits imposed on the dollar prices of tradables by international markets, and the evolution of nominal exchange rates, there was a change in the tradables/non-tradables relative price. The real exchange rate of the shequel appreciated, reducing the price competitiveness of the economy. Real wages rose more in the tradables sector, reducing its profitability. By contrast, the demand for tradables may have strengthened following the change in relative prices.

16. During 1988, the rise in nominal wages was less pronounced than in the previous year, and there was a drop in the price of imported raw materials. Together with the reduction in demand pressures, as indicated by the drop in aggregate demand growth to 0.6 per cent, these developments helped to offset increased upward pressure on prices elsewhere in the economy, particularly in agricultural and food products and non-tradable services.

17. During the first seven months of 1989, the consumer price index increased by 16.4 per cent (an annual rate of almost 30 per cent). During the same period, the shequel depreciated more than 17 per cent with respect to the same period of the previous year, putting renewed upward pressure on the domestic currency price of tradables. Widespread reductions in food subsidies and decontrol of some prices also increased the consumer price index. Fuel prices and those of small cars rose due to an increase in taxes. On the supply side, the minimum wage was adjusted in April 1989 to

compensate for the change in the cost of living over the period February 1988-February 1989. Despite these developments, inflation is expected to slow during the rest of this year as a result of lower pressure on wages, exchange rate stability, and stagnant domestic demand.

Public finance

18. Israel's public sector consists of the central government, the major municipalities, many large non-financial public enterprises, and some public financial institutions. The central government has a significant influence in all sectors of the economy, despite its expenditure (including transfers) having fallen from 68 per cent of GNP in 1984/85 to some 52 per cent in 1988/89.[1] Overall public sector expenditure accounted for almost 60 per cent of GNP in 1988/89, down from more than 75 per cent in 1984/85 (Table 2). The deficit of the consolidated Government accounts was sharply reduced from 20.2 per cent of GNP before the stabilization programme in 1985 to 1.4 per cent in 1987/88. This was achieved both by increasing the share of revenue (from 43 per cent of GNP in 1984/85 to nearly 49 per cent in 1987/88), by reducing interest payments by a third (a result of stabilization of the level of debt relative to GDP and of lower real interest rates), and by cutting subsidies by 14 per cent. The overall deficit is expected to have been more than 3 per cent of GNP in 1988/89, the increase being explained primarily by a further reduction in the contribution of foreign grants to Government revenue. During the period 1984/85-1988/89, the deficit has been financed primarily by domestic borrowing.

19. The general government budget of 1987/88 was intended to enforce fiscal discipline through expenditure cuts in defence, transfers and net lending. Revenues dropped notably due to the expiration of some temporary tax laws, gradual elimination of import deposits, elimination of the stamp tax, a reduction in the payroll tax, and a drop in personal income and corporate tax rates. Expenditure performance was as anticipated, but an unexpected decline in the inflow of foreign grants resulted in a consolidated deficit of 1.4 per cent of GNP, compared with a surplus of 1.6 per cent in 1986/87 (Table 3). The deficit was financed by issuing domestic bonds.

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[1] Fiscal year begins on April 1.

Table 2 - Summary of General Government Finances, 1984/85-1987/88
(Millions of sheqalim)

	1984/85	1985/86	1986/87	1987/88
Revenue	11,572	21,498	28,839	31,577
Expenditure	20,333	29,365	35,194	38,358
Foreign grants	3,299	7,068	7,210	5,876
Overall balance (-)	-5,462	-799	854	-904
Financing	5,462	799	-854	904
- Net foreign borrowing	433	84	908	-517
- Net domestic financing	5,029	715	-1,762	1,421

Source: Israel-Recent Economic Developments, IMF, 1989.

Table 3 - Summary of Central Government, 1984/85-1989/90
(Millions of sheqalim)

	1986/87	1987/88	Prel. Est.[1] 1988/89	Proposed Budget 1989/90
Total expenditure and net lending	26,964	30,756	35,438	40,613
Total revenue	21,434	24,483	27,863	32,087
Foreign grants	6,383	5,193	4,994	5,430
Overall balance	853	-1,080	-2,582	-3,096
Financing	-853	1,080	2,582	3,095
- Foreign borrowing	679	-730	-1,610	-597
- Domestic borrowing	1,580	1,163	4,206	3,713
- Bond sales	1,831	1,163	2,478	2,982
- Net credit from Bank of Israel	-251	-.-	1,728	731
- Other[2]	-3,111	647	-15	-20

[1]Estimate based on approved budget, supplementary budget, and cash outturn.

[2]Change in deposits in the banking system.

Source: Israel-Recent Economic Developments, IMF, 1989.

20. Defence expenditures fell from more than 32 per cent of total expenditures and net lending in 1985/86 to less than 30 per cent in 1987/88, with a shift of defence purchases from foreign to domestic sources. The stabilization of the government debt allowed some loan repayment, which in turn contributed to a decline in real interest rates. The share of interest payments in total outlays dropped from almost 25 per cent in 1984/85 to 20.5 per cent in 1987/88 (from almost 17 per cent to just over 11 per cent of GNP). Outlays on social services and welfare increased in relative importance during the period. The Government also corrected some inflation-induced fiscal inequities reducing income and property taxes through the indexation of tax brackets and rates. In an effort to reduce companies' costs and to increase investment, payroll and employers' taxes were also cut. Income tax rates on individuals and corporations were also reduced. The yield from taxes on external transactions also fell as part of the import liberalization programme.

21. Preliminary estimates for the 1988/89 central government budget show a worsening of the deficit from 1.9 per cent of GNP to almost 4 per cent of GNP, largely as expected. Expenditure continued to fall to 52.6 per cent of GNP from 54.1 in the previous year. However, total revenue is estimated to have dropped by 2 percentage points to 41.3 per cent of GNP.

22. In 1988/89, interest payments (86 per cent of the budget deficit before foreign grants) and defence expenditures fell to 18.5 per cent and 28.5 per cent of total outlays respectively. At the same time, subsidies on basic commodities and services rose to 33 per cent of total expenditure. Higher than expected inflation and the 1988 wage agreement increased wage and salary expenditures to almost 16 per cent of total outlays. The decrease in tax revenue can be traced mainly to the poor performance of the external sector and a fall in revenue from domestic taxes on goods and services caused by weakened domestic demand. By contrast, revenue from individual income taxes rose as a percentage of GNP due partly to higher real wages and partly to the effects of inflation (which were not fully offset by the above-mentioned tax reform).

23. In 1988/89, the Government used central bank credit to finance repayments of foreign debt and the purchase of collateral used in the refinancing of $4.8 billion in long-term military loans. Also in 1988/89, the Government had to float debt to fulfil its commitment to purchase almost $4 billion of commercial bank equity following the collapse of bank shares of Israeli banks in 1983, and to repay compulsory loans from the public obtained during the 1973-74 war.

24. The budget for 1989/90 seeks to maintain a tight fiscal policy, targeting a deficit of 4 per cent of GNP (excluding the National Insurance Institute accounts). As the share of foreign grants is expected to drop to 6.8 per cent of GNP, and as a decline of revenues to 40.2 per cent of GNP is anticipated, a reduction in expenditures of 1.7 per cent of GNP is required. The deficit is again to be almost completely financed by domestic borrowing. The budget plans involve cuts in defence outlays, employment in the administration and subsidies. A decline in revenue from customs duties is expected to result from the implementation of the trade agreements with the United States and the European Communities. Furthermore, the reduction in inflation and the slowdown in the growth of

real wage will further reduce income tax receipts. Revenue from corporation taxes is also expected to drop.

25. The National Insurance Institute (NII) is a public entity that reports to the Ministry of Labour and Welfare. It has a social rôle, in particular the payment of pensions; of injury, unemployment and war invalid benefits; of income support and specific help to parents of children who served in the army. The deficit of the NII is expected to be about 1 per cent of GNP in 1989/90 after having peaked at 2 per cent in 1985/86.

26. The financial situation of local authorities has improved since 1986/87, when they recorded the first surplus in many years (0.2 per cent of GNP). After the introduction in 1985/86 of a law forbidding local authorities from borrowing from the banking system without the authorization of the Ministry of Finance, the financial performance of the local authorities improved reflecting an increase in own revenue as the share of grants and transfers in the total revenue of the local authorities dropped from more than 46 per cent in 1986/87 to about 17 per cent in 1987/88 and 1988/89. The local authorities' expenditures have shifted toward wages and salaries and away from budget transfers and capital outlays.

Money and credit

27. At the end of 1987, the Israeli financial system was composed of 29 commercial banks subject to liquidity regulations, 14 mortgage banks, 8 investment finance banks, 11 financial institutions not fully subject to liquidity regulations, and 3 joint service companies. The two largest banks account for over 70 per cent of commercial bank credit to the private sector. The sector is subject to widespread indexation, following years of high inflation. In mid-1985, 92 per cent of short-and long-term financial assets (excluding shares) were indexed. Sixty-five per cent of short-term credit was denominated in foreign currency. At the end of 1988, more than 83 per cent of short-term and medium-term financial assets were still indexed. Therefore, the "controllable" money supply is limited to non-indexed sheqalim, which represented less than 23 per cent of total bank credits at the end of 1987.[2] Control over the cost of credit is limited to new lending in unlinked sheqalim, mainly short-term. Medium- and long-term credits are regulated and influenced by the Government. A high proportion of medium-term and long-term bank credits is earmarked for preferred sectors and is extended at subsidized interest rates.

28. After the rapid increase in credit to the private sector in the first three quarters of 1986, policy measures to increase nominal interest rates were adopted. This moved real interest rates upwards. Given public

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[2]Note that despite reductions in reserve requirements, the monetary base (currency in circulation plus deposits of depository institutions) still represented a high proportion of broadly defined money at the end of 1988, 30 per cent as against 34 per cent the previous year.

concerns about high real marginal rates, the Bank of Israel resumed its efforts to lower interest rates from April 1987. Short-term interest rates fell in the second half of 1987 and domestic credit growth accelerated (Table 4).

Table 4 - Factors affecting changes in broad monetary liabilities
(Annual percentage change)

	1985	1986	1987	1988
Net foreign assets	*	2,357	110	-51.9
Net domestic assets	170.4	17.2	17.4	19.1
- Domestic credit	181.1	16.0	20.6	20.8
- Claims on government	184	3.9	8.8	15.8
Mortgage banks	203.9	25.8	23.3	17.4
Private sector	173.4	36.4	36.2	26.8
Other items, net	4,688	-10.4	118.7	51.5
Broad money	168.5	20.8	27.2	19.2
Memorandum item:				
Consumer price index	185	20	16	16

*The level of net foreign assets in 1985 was 67 million of new sheqalim as against -376 million in 1984.

Source: Israel-Recent Economic Developments, IMF, 1989.

29. From November 1987, the monetary authorities began paying closer attention to the coordination of domestic credit policy with the desired evolution of the balance of payments and the exchange rate. Reflecting a more restrained credit policy and the slowdown in the economy, the expansion of domestic credit moderated in the first quarter of 1988 to 3.6 per cent as against 7.2 per cent in the first quarter of 1987. Interest rates stopped declining. However, in mid-1988, increasing signals of slow economic growth moved the Bank of Israel to increase the amount of loans available for tender, to lower bank reserve requirements and - since the third quarter of 1988 - to increase its purchases of six-month Treasury bills. Short-term interest rates again declined from April to October 1988. Domestic credit expanded more than 16 per cent between April and the end of 1988, as against 12.5 per cent during the same period of the previous year.

30. The Bank of Israel came under pressure to sell foreign assets in the second half of 1988 in response to speculation that the sheqel would be devalued: foreign assets dropped from $5.7 billion at end-June 1988 to $4.4 billion at end-December 1988. Interest rates rose from October 1988 in order to reduce pressure on reserves. Due to a widening of inflation differentials between Israel and the five countries included in its currency reference basket[3], these measures were insufficient to avoid a two-step devaluation, first, by 4.8 per cent in late December 1988, which failed to reduce market pressure on the currency, and subsequently, a further devaluation in January 1989 to a level 13.5 per cent below the level preceding the first devaluation. Speculation ceased, and at the end of February of this year, net foreign assets were at the same level as at the end of June 1988. This factor helped to reduce the rate of expansion of broad money from 27.2 per cent in 1987 to 19.2 per cent in 1988. Aggregate M3 (defined as M1 plus short-term certificates of deposit, foreign currency denominated deposits and time deposits) rose by 4.1 per cent in 1988 against an increase of almost 30 per cent in 1987.

31. Since the 1985 stabilization programme, bank credit to the Government has increased modestly in nominal terms, but has declined in real terms because of the fall in the public sector deficit. In contrast, as the rate of inflation fell, total bank credit to the private sector increased both in nominal and real terms. Within this group, the share of directed credit (mostly in foreign currency and for export activities) was halved between December 1986 and December 1988. Non-directed credit in U.S. dollars (roughly 50 per cent of which is rationed, and the rest approved in most cases for export-related activities) fell from 13.1 per cent of total bank credit at the end of 1986 to about 5.5 per cent at the end of 1988. Credit for domestic activities in sheqalim (virtually unrestricted in price and quantity) grew most rapidly in real terms. Medium- and long-term credit, which is mostly indexed and has a maximum real interest rate of 13 per cent, has decreased its share in total credit since 1985.

32. After the stabilization programme of 1985, the fact that real interest rates remained high has been a source of concern (Table 5). Efforts to reduce real rates of interest have resulted in a decrease in rates on short-term credit and overdraft facilities in the last two years. However, real rates of return on time deposits and certificates of deposits have been negative. High reserve requirements yielding relatively low returns, and regulations affecting the allocation and the quantity of credit available for specific purposes, have resulted in high operating costs for financial intermediaries. Given the degree of market segmentation and concentration produced by government policies, this has resulted in a reduction in liquidity, reflected in a large spread between the effective rate on overdrafts and on certificates of deposit.

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[3]The basket consists of the US dollar, Deutschmark, French franc, Japanese yen and pound sterling.

Table 5 - Real Interest Rates on Various Types of Credit and the Public's Assets, 1986/88

	1986	1987	1988
Short-term bank credit to the private sector[1]	8.2	18.8	13.8
of which:			
Overdraft facilities	33.4	38.5	25.4
Time deposits for one month	-0.9	2.5	-2.4
Private capital issues[2] (indexed)	7.6	6.7	6.2
Six-year government bonds (indexed)	6.0	4.8	4.0
Interest rate spread[3]	36.1	37.7	31.3

[1]Includes an imputed 1.6 percent cost of floating an issue.

[2]Average for July-December 1986.

[3]Interest rate differential defined as the gap in nominal percentage points on an annual basis between the effective rate on overdrafts and the rate on certificates of deposit.

Source: Israel-Recent Economic Developments, IMF, 1989.

33. In recent years, the Government has promoted competition in the capital market and has taken a number of measures to reduce its own involvement in the market. In April 1987, private companies were allowed to issue bonds. Non-negotiable government bonds with subsidized interest rates for provident and pension funds and bank-managed saving schemes are being phased out. The share of special non-negotiable indexed bonds that such institutions are required to hold was reduced. Reserve requirements for saving schemes denominated in foreign currencies have also been reduced. Insurance companies have been given more latitude in the allocation of their funds. The main economic changes resulting from these measures have been an increase in the proportion of negotiable bonds in total gross bond issues from 6 per cent in 1984 to 66 per cent in 1988, and a reduction in the cost of issuing private and Government bonds.

Balance of payments

(a) The current account

34. The stabilization programme of 1985 had as an objective the strengthening of Israel's current account position. In 1985 and 1986, the current account recorded surpluses of 4.8 and 5.3 per cent of GDP (Graph 3), as against a deficit of 5.4 per cent of GDP in 1984. However, as supplemental intergovernmental aid from the United States ended and the trade deficit almost doubled to $3.8 billion, the current account fell into deficit of 2.8 per cent of GDP in 1987 (Table 6). In 1988, as economic growth slackened, the current account deficit fell by almost one per cent of GDP to some $675 million.

Graph 3 – Current Account Balance
(Percentage of GDP)

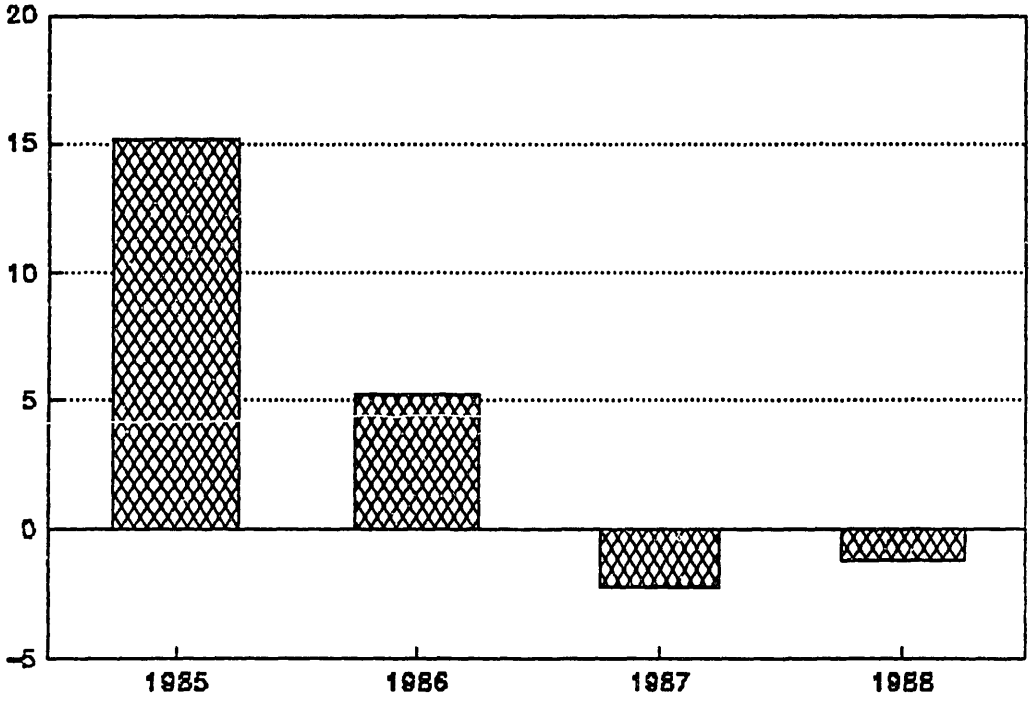


Table 6 - Balance of Payments 1985-88
(Million US dollars)

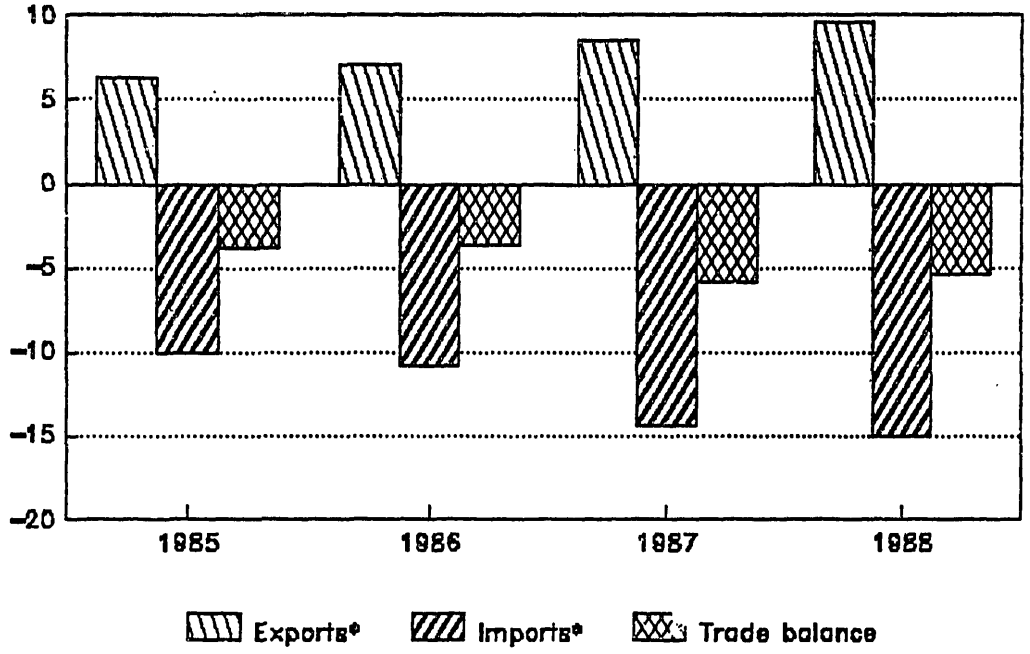
	1985	1986	1987	1988
Trade balance	-2,439	-1,941	-3,831	-3,145
Exports (f.o.b.)	6,602	7,674	9,065	10,013
Imports (f.o.b.)	-9,041	-9,615	-12,896	-13,158
Invisibles balance	-1,408	-1,887	-1,976	-2,181
of which:				
Transfers net	4,997	5,381	4,839	4,651
Current account balance	1,150	1,553	-968	-675
Medium- and long-term capital, net	94	520	520	-652
Commercial banks, net	-22	-118	-.-	-516
Private short-term capital, net	-320	-292	-187	-92
Government short-term capital, net	-122	-642	732	589
Errors and omissions	-379	-30	656	176
OVERALL BALANCE	400	992	752	-1,170
Increase (-) in reserves	-400	-992	-752	1,170

Source: IMF.

(b) The merchandise trade balance

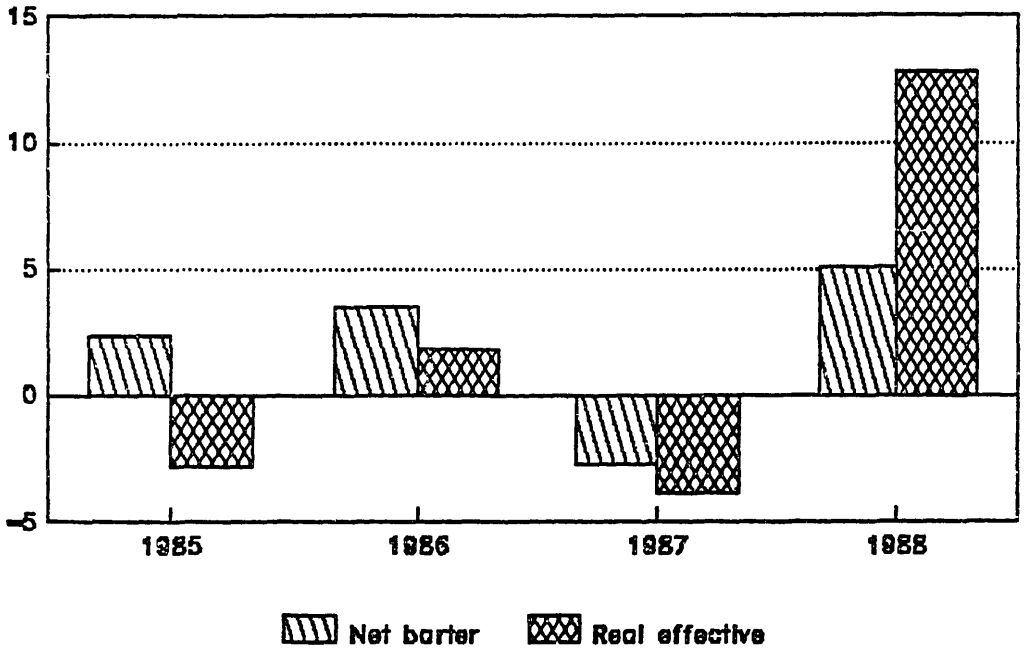
35. Israel's trade deficit of Israel in 1987 (on a customs basis) was $5.9 billion, up almost 60 per cent from 1986 (Graph 4). On the same basis, the civilian trade deficit rose by 37 per cent to $3.2 billion from $2.3 billion in the previous year, as a consequence of rapid economic growth and a terms of trade deterioration of 2.7 per cent (Graph 5). In 1988, as the economic downturn started, the overall trade deficit fell by almost 8 per cent to $5.4 billion and the civilian deficit to $2.8 billion, or by nearly 13 per cent. The terms of trade improved by 5.1 per cent.

Graph 4 – Value of merchandise trade, 1985–88
(Billion US dollars)



*Customs basis.

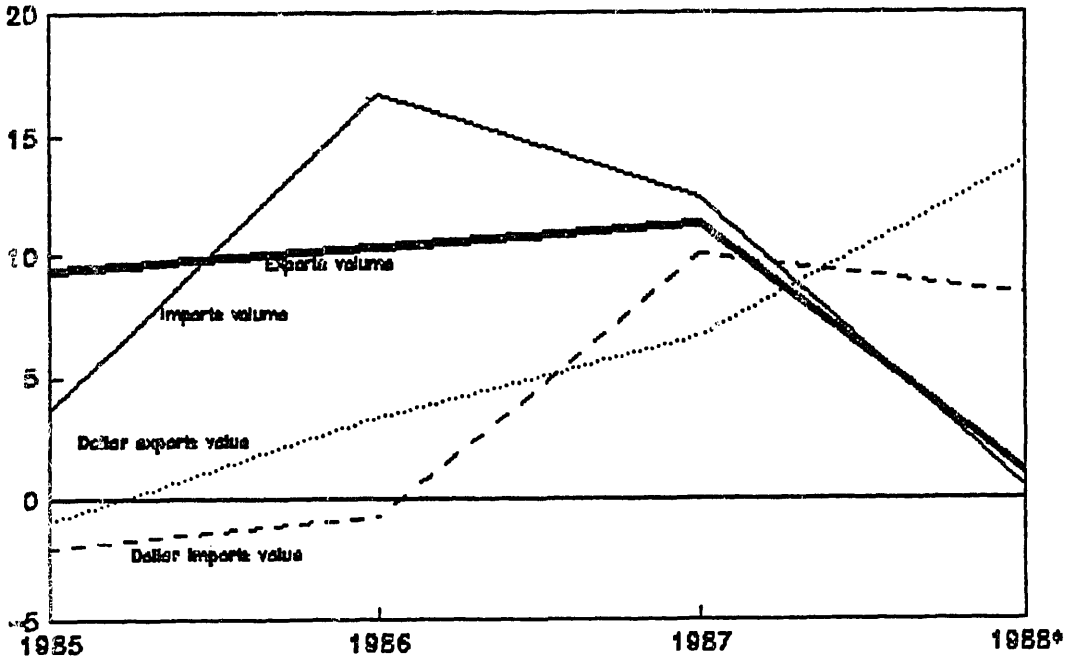
Graph 5 – Net Barter Terms of Trade and Real Effective Exchange Rate
(Annual % change;end of period)



Note:Fourth quarter over fourth quarter.

36. In 1987, civilian exports grew by 18.6 per cent in dollar value terms and 11.3 per cent in volume terms (Graph 6). A contributing factor was the depreciation of the real effective exchange rate (based on unit labour costs) of the shequel. The 14.7 per cent growth of civilian exports in nominal value in 1988 masked a significant drop in the growth of export volume to just 1 per cent. Adverse weather, the effects of civil unrest, and a 12 per cent appreciation of the real effective exchange rate of the shequel were key factors behind this trend.

Graph 6 – Volume and value of merchandise trade, 1985–88
(Annual % change)



*Estimates

37. During 1987, the value export growth of diamonds slowed to about 24 per cent and agricultural products to 9.5 per cent, while exports of industrial products grew by almost 18 per cent (Table 7). High local labour costs and competition in European markets affected the volume of exports of agricultural products. In 1988, exports of diamonds continued their buoyant trend, favoured by price developments. Industrial exports rose by more than 13 per cent. Within this category, the volume of exports of food products and textiles declined; however, increased prices for these products offset the falls in volume. Supply difficulties due to weather conditions affected agricultural exports, which declined by almost 6 per cent in value terms and nearly 20 per cent in volume.

Table 7 - Changes in the Pattern of Israel's Merchandise Exports[1]
(Million US dollar)

	1985	1986	1987	1988	% change 1988 over 1986
Food[2]	383	333	436	518	55.5
Diamonds	1,263	1,665	2,059	2,547	52.[illegible]
Chemicals	835	792	1,039	1,154	45.[illegible]
Textiles[3]	379	466	592	639	37.1
Other light industry products	535	628	756	841	33.9
Metals, machinery and electronics	1,928	2,204	2,430	2,817	27.8
Ores and minerals	256	249	252	262	5.2
Agricultural products	469	560	613	578	3.2
of which:					
Citrus fruit	172	174	205	177	1.7
TOTAL[4]	6,084	6,914	8,217	9,434	36.4

[1] Including returned exports, excluding exports to administered area.

[2] Including beverages and tobacco.

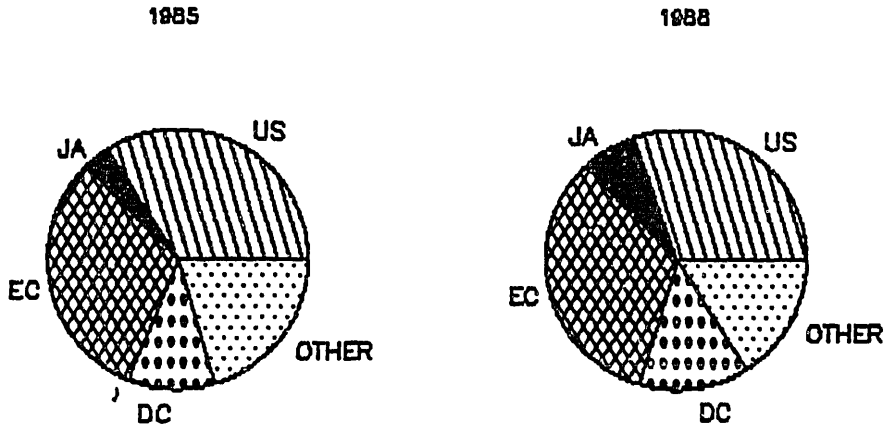
[3] Including clothing and leather products.

[4] Numbers do not sum because total includes "other exports", mainly scrap metal.

Source: Israel-Recent Economic Developments, IMF, 1989.

38. In the last two years an increasing share of Israel's exports has been sold to Japan, the European Communities and developing countries, while the United States' share has declined (Graph 7). In 1988, exports to the United States accounted for 30.5 per cent of the total, down from their peak of about 34 per cent in 1985. The share of the European Communities in Israel's exports was 33.1 per cent in 1988, with the United Kingdom having the largest share (almost 8 per cent).

Graph 7 –REGIONAL PATTERN OF MERCHANDISE EXPORTS, 1985–88*
(Percentage shares)



Total: US$ 8 280 million

Total US$ 9 805 million

*Customs basis.
Note: NA refers to North America; EC refers to the European Communities; JA refers to Japan; DC refers to Developing Countries.

39. The value of civilian imports (on a customs basis) grew by more than 23 per cent in 1987 to $11.5 billion, from about 16 per cent the previous year (Table 8). Volume growth was 12.4 per cent, down from almost 17 per cent in 1986. In 1988, as demand conditions weakened, imports were $12.2 billion, a rise of 7 per cent in value but with almost no growth in volume terms.

Table 8 - Changes in the Pattern of Israel's Merchandise Imports[1]
(Million US dollar)

	1985	1986	1987	1988	% change 1988 over 1986
Consumer goods	621	1,029	1,334	1,523	48.0
Input goods	6,162	6,846	8,222	8,921	30.3
of which:					
Diamonds (less returned)	1,168	1,598	1,901	2,413	51.0
Investment goods	1,414	1,604	2,142	2,049	27.7
Fuel	1,510	924	1,148	1,062	14.9
TOTAL[2]	8,021	9,275	11,451	12,250	32.1

[1]Excluding imports from administered areas and direct imports of military goods.

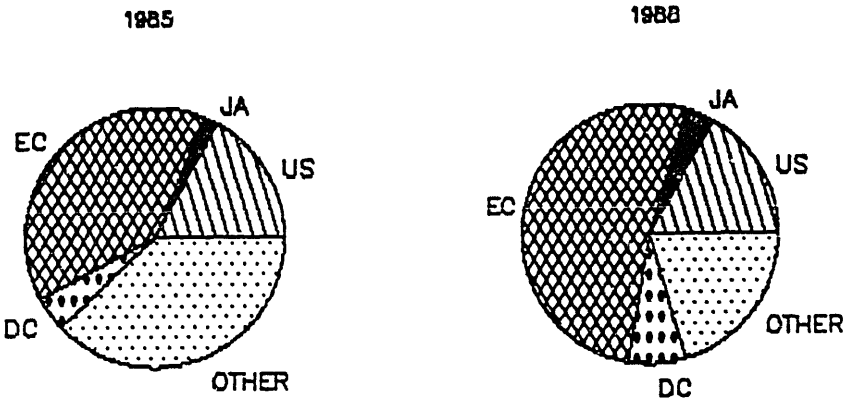
[2]Data do not add up because total excludes and detail includes returned imports.

Source: Israel-Recent Economic Developments, IMF, 1989.

40. In 1987, imports of investment goods grew by more than 33 per cent, recovering from the sluggish growth of the previous year. Imports of consumer goods rose by almost 30 percent; as in 1986, durables were the most rapidly growing category. In 1988, the import bill for investment goods fell by more than 4 per cent; within this category, imports of plant and equipment dropped by more than 8 per cent in volume. Sluggishness in the economy explains much of this fall in the volume of production inputs. Expectations of a devaluation at the end of 1988 increased the volume of imports of durable goods, which therefore grew at almost the same rate as in the previous year.

41. The relative importance of the European Communities and Japan as suppliers to Israel has continued to increase in the last two years (Graph 8). In 1988, the European Communities supplied almost 52 per cent of Israeli imports and Japan nearly 4 per cent. Within the European Communities, the main suppliers were Belgium-Luxembourg (15 per cent) and the Federal Republic of Germany (over 11 per cent). The United States' share has fluctuated around 16 per cent, a modest decline from about 18 per cent in 1984 and 1983.

Graph 8 –REGIONAL PATTERN OF MERCHANDISE IMPORTS, 1985–88*
(Percentage shares)



*Customs basis
Note: NA refers to North America; EC refers to the European Communities; JA refers to Japan; DC refers to Developing Countries.

(c) The invisibles balance

42. The reduction in the invisibles surplus in 1987 was mainly due to a drop in transfers to $4.8 billion from nearly $5.4 billion in 1986, resulting from a reduction of almost $800 million in assistance from the United States. This was partly offset by a continuing rise in private transfers for the second year in a row. Transactions in services showed a modest increase in net travel receipts and declines in net receipts in all other categories, except for investment income. In 1988, the invisibles surplus declined to $2.5 billion, mainly in private and intergovernmental transfers and in services. Net receipts from tourism, freight and transportation, and investment income declined.

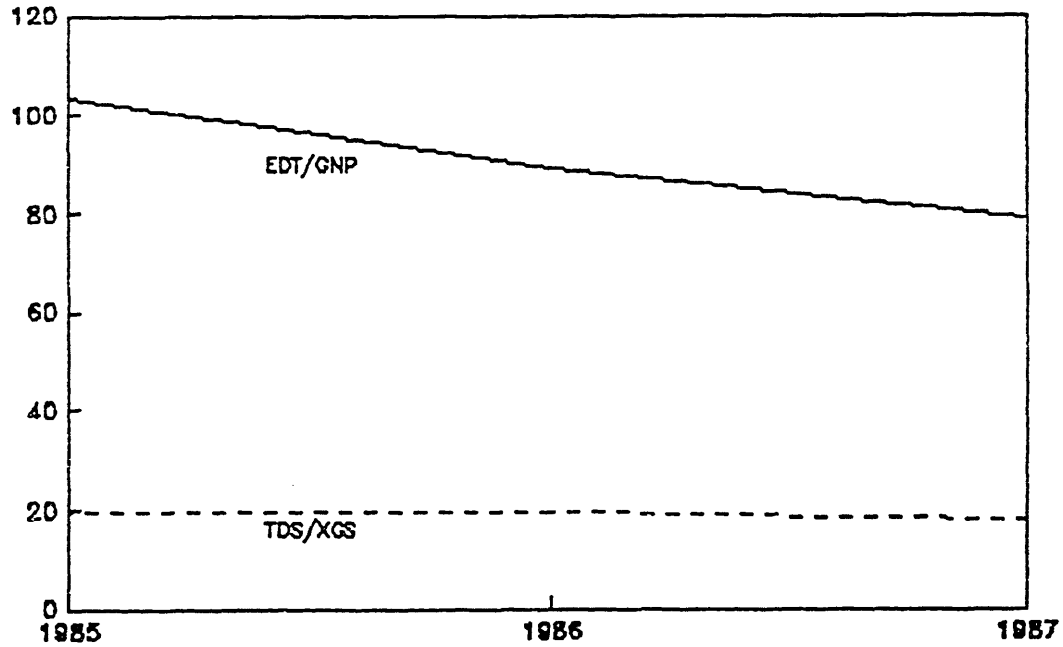
(d) The capital account and the external debt

43. Following the devaluation of the shequel in January 1987, private capital inflows (mainly short-term) increased strongly. Medium- and long-term private capital inflows also rose by more than 170 per cent, while there was a marked decrease in official medium- and long-term capital inflows. Short-term net capital inflows totalled more than $700 million. With a surplus on capital account, the level of international reserves (excluding gold) rose to $5.9 billion. In the first half of 1988, private net outflows of medium- and long-term capital reached almost $800 million while short-term outflows declined. As expectations of a devaluation generalized in the second half of 1988, the central bank sold about $2.5 billion to the private sector. Similarly, foreign exchange had to be

provided to the public sector for a debt conversion operation. Overall, external reserves of the central bank declined to $4 billion. It is reported that a substantial reversal of the capital outflow took place after January 1989 devaluation. In April, external reserves recovered their December 1987 level, but have declined since to $5.3 billion at end-June 1989 (equivalent to about three months of imports).

44. According to the World Bank, Israel's total external debt grew by 5.1 per cent in 1987 mainly as a result of the effect of the appreciation (with respect to the dollar) of the major currencies in which the debt is denominated (Graph 9). The total external debt represented almost 79 per cent of GNP, down from 89 per cent in 1986. In 1988, according to preliminary estimates, the total external debt of Israel declined by almost 3 percent to about $25.6 billion. The Government share of this debt, although shrinking, is still 64 per cent. In 1987, the share of short-term debt was of almost 15 per cent of the total. Preliminary data for 1988 suggest no significant change in the situation. The servicing of the foreign debt represented almost 18 per cent of total exports of goods and services in 1987, as against nearly 20 per cent in 1986. According to national sources, the ratio may have deteriorated in 1988 due to higher interest rates and an increase in principal repayments.

Graph 9 – External Debt Indicators
(Percentages)



Note: EDT refers to total external debt, TDS refers to total debt service; XGS refers to exports of goods and services.